LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
JAN 17 1966
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH, *Petitioners*

v.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

WILLIAM LEE MCLANE
NOLA MCLANE
THADDEUS ROJEK
2101 Connecticut Avenue, N.W.
Washington, D. C.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX

	Page
Opinion Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Rules Involved	2
Statement	3
Reasons for Granting the Writ	5
I. The unjustified outright refusal of the Court of Claims to grant leave to Petitioners to file an Amended Petition constitutes an abuse of discretion which can only be corrected here	5
II. The action of the Court of Claims in granting a motion for summary judgment while a motion to amend the Petition was pending conflicts with decisions of the Courts of Appeals	7
III. The Court of Claims disregarded the directions of this Court and the Courts of Appeals that summary judgment is not appropriate where ultimate facts respecting motive must be made	9
IV. The Court of Claims acted in conflict with the decisions of the Courts of Appeals by drawing fact inferences as to purpose and intention on a motion for summary judgment	11
V. The Court of Claims acted in conflict with the decisions of this Court and with those of the Courts of Appeals by granting summary judgment herein when there exist genuine issues of material fact	15
VI. The government was not entitled to summary judgment as a matter of law in view of the decisions of this Court and the Court of Claims	17
Conclusion	23
Appendix A (Opinion and Judgment of the Court of Claims)	1a
Appendix B (Statutes and Rules Involved)	17a

AUTHORITIES CITED

Cases:	Page
Alabama Great So. R.R. v. Louisville & Nashville R.R., 224 F. 2d 1	9
Assets Service Corporation v. United States, 121 Ct. Cl. 308	15
Bragen v. Hudson County News Co., 278 F. 2d 615	11
Branch Banking & Trust Co. et al. v. United States, 98 F. Supp. 757	19
Brecklein v. Bookwalter, 231 F. Supp. 404	19
Breier v. Northern California Bowling Proprietors' Assn., 316 F. 2d 791	8
Castner v. First National Bank of Anchorage, 278 F. 2d 376	8
City Loan & Savings Co. v. United States, 177 F. Supp. 843	18
Connecticut Railway & Lighting Co. v. United States, 142 F. Supp. 907	19
Cross v. United States, 336 F. 2d 431	9, 11
Dixon v. United States, 381 U.S. 68	18
Empire Electronics Co. v. United States, 311 F. 2d 175	9
Exchange Parts Co. of Fort Worth v. United States, 279 F. 2d 251	18
Foman v. Davis, 371 U.S. 178	7
Friedman v. Typhoon Air Conditioning Co., Inc., 31 F.R.D. 787	6
Garcia v. United States, 108 F. Supp. 608	12
Gray Tool Co. v. Humble Oil & Refining Co., 186 F. 2d 365	11
Gregory v. Helvering, 293 U.S. 465	21
Hartman v. Time, 64 F. Supp. 671	8
International Business Machines Corp. v. United States, 343 F. 2d 914	18
Joseph Horne Co. v. United States, 135 F. Supp. 549	15
Kane v. Chrysler Corporation, 80 F. Supp. 360	8
Krieger v. Ownership Corporation, 270 F. 2d 265	14
McHenry v. Ford Motor Co., 269 F. 2d 18	6
Mahoning Inv. Co. v. United States, 3 F. Supp. 622	19
Martucci v. Mayer, 210 F. 2d 259	6
Perry A. Nichols v. Commissioner, 43 T.C. 842	5, 6
Poller v. Columbia Broadcasting System, 368 U.S. 464	9, 15
Retail Clerks International Assoc. v. Lion Dry Goods, 341 F. 2d 715	8

Page

Rossiter v. Vogel, 134 F. 2d 908 8
Sartor v. Arkansas Gas Corp., 321 U.S. 620 .....14, 15
Snyder v. Dravo Corporation, 6 F.R.D. 546 8
Subin v. Goldsmith, 224 F. 2d 753 9
United States v. Diebold, 369 U.S. 654 .....14, 17
United States v. Dollar, 196 F. 2d 551 15
United States v. International Business Machines Corp., No. 820, October Term, 1965 .....5, 13
United States v. Kaiser, 363 U.S. 299 18
United States v. Western Electric Co., 337 F. 2d 568 .. 17
Weir v. Commissioner, 109 F. 2d 996 20
White Motor Co. v. United States, 372 U.S. 253 9

STATUTES:

Internal Revenue Code of 1954:

Section 165(c)(2) 20, 22, 17a
Section 165(e) 5
Section 212(2) 20, 17a

RULES OF THE UNITED STATES COURT OF CLAIMS:

Rule 22(a) 17a
Rule 30(a) 13, 18a
Rule 64(d) 15, 18a

MISCELLANEOUS:

3 Moore, Federal Practice §§ 15.02(2), 15.08(2) 6, 7
6 Moore, Federal Practice § 56.03 6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No.

KARL F. KNETSCH AND EVA FAY KNETSCH, *Petitioners*

v.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Petitioners pray for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINION BELOW

The opinion of the Court of Claims (Appendix A, *infra*, pp. 1a-16a) is reported at 348 F. 2d 932.

JURISDICTION

The judgment of the Court of Claims was entered on July 16, 1965 (App. A, *infra,* p. 16a), and Petitioners' motion for rehearing was denied on October 15, 1965. (R. 329-330).* Also, on October 15, 1965 the Court of Claims entered an order denying Petitioners' motion to file an amended petition (R. 223). The jurisdiction of this Court is invoked under 28 U.S.C. § 1255(1).

QUESTIONS PRESENTED

Whether an unjustified outright refusal of a trial court to grant a plaintiff's motion for leave to file an amended petition constitutes an abuse of discretion.

Whether a motion for summary judgment may be granted for a defendant while a motion to amend plaintiff's petition is pending.

Whether summary judgment is appropriate where ultimate facts respecting motive or intent must be made.

Whether a trial court, on a motion for summary judgment, may draw inferences as to plaintiffs' purposes of intentions.

Whether genuine issues of material fact were present which precluded the granting of summary judgment.

Whether the Government was entitled to summary judgment as a matter of law.

STATUTES AND RULES INVOLVED

The pertinent portions of the Internal Revenue Code of 1954 and the Rules of the Court of Claims are set forth in Appendix B, *infra,* pp. 17a-18a.

* By order dated January 13, 1966, the Chief Justice extended the time for filing a Petition for a Writ of Certiorari to and including January 17, 1966.

STATEMENT

The Court of Claims granted the Government's motion for summary judgment and dismissed the Knetsch petition. (R. 312). In its motion the Government stated: "Solely for purposes of this motion the allegations of well-pleaded facts in taxpayers' petition are taken as true". (R. 18). Thus, it conceded as true paragraph 22 of the Petition which states:

> "On January 18, 1957, the Commissioner of Internal Revenue stated to the United States House of Representatives' Subcommittee on Internal Revenue Taxation, in formal hearings before that Subcommittee, that, while interest deductions claimed in regard to annuity transactions were being denied taxpayers who claimed same, the Internal Revenue Service was, *as a matter of policy, allowing* such taxpayers a deduction for their net out-of-pocket *loss* realized from such annuity transactions where the taxpayer had acted in reliance on references in trade magazines and the tax services to the issuance of private rulings by the Treasury Department stating that interest paid in connection with such annuity transactions was deductible for income tax purposes."[1]

The Government, in like manner, also conceded that Petitioner Karl F. Knetsch had purchased ten (10) annuity contracts while relying upon publicized private rulings of the Internal Revenue Service which held that the interest paid in connection with the purchase of such annuities was deductible,[2] and that the interest deductions claimed by Petitioners with regard to such

---

[1] Petition, pgh. 22, R. 7. (Emphasis supplied).

[2] Petition, pghs. 4-6, R. 2-3. The Government verified said allegations before it filed its motion for summary judgment by taking the deposition of Petitioner Karl F. Knetsch.

annuity transactions had been denied them,[3] and that the Petitioners had terminated the said annuity transactions in 1956 at which time they realized a net out-of-pocket loss in the amount of $137,315.[4]

Despite the foregoing declaration of policy, the Commissioner of Internal Revenue denied the $137,315 net out-of-pocket loss claimed by Petitioners on their 1956 federal income tax return filed on or about April 15, 1957.[5] Petitioners thereupon paid the resulting assessment of $86,508.92 plus interest of $19,301.87, and then filed a timely claim for refund.[6] After disallowance of such claim for refund, Petitioners sued for the refund of the said sum of $105,810.79 in the Court of Claims.[7]

Subsequently, the Government filed its motion for summary judgment. (R. 18). Petitioners then filed a cross-motion for summary judgment. (R. 107). While these motions were pending, and more than a month prior to the hearing on both motions for summary judgment, Petitioners, on March 5, 1965, filed a motion for leave to file an amended petition and a copy of said amended petition. (R. 223-234). Although the Government had filed no opposition to the said motion to amend the petition, the Court of Claims, on March 10, 1965, entered an order stating that action on the motion for leave to file an amended petition was deferred pending the Court's action on the motions for summary judgment!

---

[3] Petition, pghs. 7-18, R. 3-5.

[4] Petition, pghs. 19-21, R. 6-7.

[5] Petition, pgh. 23, R. 7.

[6] Petition, pghs. 27-30, R. 8-9.

[7] Petition, pghs. 30-34, R. 9-10.

Later on July 16, 1965, the Court of Claims granted the Government's motion for summary judgment without having ruled on Petitioners' motion for leave to file an amended petition. Thereafter, on October 16, 1965, the Court of Claims entered an order denying Petitioners' motion for leave to file an amended petition. No reasons for said denial were given, and no hearing was held thereon.

One of the major issues raised in this petition, and set forth in Point VI under Reasons For Granting The Writ, is also the subject of a Petition for Writ of Certiorari filed on December 13, 1965, by the Solicitor General in *United States* v. *International Business Machines Corporation,* No. 820, October Term, 1965.

REASONS FOR GRANTING THE WRIT

The reasons why a writ of certiorari should be granted are as follows:

I

The Unjustified Outright Refusal of the Court of Claims to Grant Leave to Petitioners to File an Amended Petition Constitutes an Abuse of Discretion Which Can Only Be Corrected Here

On March 5, 1965, when Petitioners moved the Court of Claims to enter an order granting them leave to file an amended petition setting forth three additional alternative theories for recovery,[8] they asserted that

---

[8] One of the three newly asserted theories for recovery was that the Petitioners were entitled to a theft loss under Section 165 (e). (R. 230-232). Thereafter, on March 24, 1965, and before the motion for summary judgment was heard here, the Tax Court, in a case of first impression (opinion by Judge Raum, no dissenters), held that the taxpayers in Perry A. Nichols v. Commissioner, 43

their rights would be impaired if not permitted to file the said amended petition because a ruling in favor of the Government on its then pending motion for summary judgment would foreclose them from thereafter asserting such additional alternative theories as grounds for the recovery of their claimed refund.[9] Nevertheless, and even though the Government had filed no opposition thereto,[10] the Court of Claims deferred action on said motion to amend the petition and proceeded on April 7, 1965 to hear oral argument on the pending motions for summary judgment. On July 16, 1965, the Court of Claims granted the Government's motion for summary judgment and dismissed the petition. Thereafter, but not until October 15, 1965, and without any hearing being noticed or held, the Court of Claims denied Petitioners' motion for leave to file an amended petition. When it did so,

---

T.C. 842, who had engaged in one of the now notorious "Livingstone Treasury Note tax avoidance schemes" were entitled to a theft loss deduction for the moneys they paid out to Livingstone in reliance on Livingstone's false representations. The deduction allowed was, of course, equal to the net out-of-pocket expense incurred in the said "sham transaction" therein. The Government's appeal in the Nichols case, supra, was withdrawn on December 8, 1965.

[9] Summary judgment goes to the merits and operates in bar of the cause of action. Martucci v. Mayer, 210 F. 2d 259, 260, and authorities collected therein. See also 6 Moore, Federal Practice § 56.03.

[10] Under the modern view of permitting liberal amendment of pleadings so that cases are ultimately decided on their substantive merits, the burden of proof is upon the party opposing the amendment to show that he would be *prejudiced* thereby. McHenry v. Ford Motor Co., 269 F. 2d 18, 25 (C.A. 6, 1959); Friedman v. Typhoon Air Conditioning Co., Inc., 31 F.R.D. 787 (E.D. N.Y., 1962); 3 Moore, Federal Practice §§ 15.02 [2], 15.08 [2].

it simply entered an order of denial. No reasons for the denial were stated.

However, in *Foman* v. *Davis,* 371 U.S. 178, after acknowledging that the granting or denial of a motion for leave to amend pleadings is, of course, within the discretion of the trial court, this Court held that an outright refusal to grant such leave without any justifying reason appearing for the refusal is an abuse of discretion and inconsistent with the spirit of modern civil practice.[11] Thus, the Court of Claims has abused its discretion, and acted in disregard of the spirit of modern rules of practice permitting liberal amendment of pleadings.

It is true that in the *Foman* case, *supra,* Mr. Justice Harlan and Mr. Justice White filed a separate memorandum in which they stated they believed that matters respecting abuse of discretion by the trial court in refusing to grant leave to amend pleadings should be left with the Court of Appeals. In this case, however, since the only reviewing court to which the Court of Claims is responsible is this Court, unless certiorari is granted here the abuse of discretion will remain uncorrected.

II

The Action of the Court of Claims in Granting a Motion for Summary Judgment While a Motion to Amend the Petition Was Pending Conflicts With Decisions of the Courts of Appeals

On July 16, 1965, while Petitioners' motion for leave to file an amended petition was pending, the Court of Claims granted the Government's motion for summary judgment and dismissed Petitioners' petition. Such

[11] See discussion in 3 Moore, Federal Practice § 15.02 (2) at 815.

conduct conflicts with decisions of the Court of Appeals.

Most recently, the Sixth Circuit, in *Retail Clerks' International Assoc.* v. *Lion Dry Goods,* 341 F. 2d 715, 723 (C.A. 6, 1965), held that ". . . where an amended pleading has been tendered and permission to file it should be given, an adversary motion for summary judgment should not be granted before it is filed and considered . . ." In like fashion, the Ninth Circuit, in *Castner* v. *First National Bank of Anchorage,* 278 F. 2d 376, 384 (C.A. 9, 1960), held that where an amendment of the pleadings is justified, that amendment ought not to be prevented by the entry of a final summary judgment on defendants' motion, and that the trial court had to be reversed for doing so under such circumstances. See further: *Rossiter* v. *Vogel,* 134 F. 2d 908, 912 (C.A. 2, 1943); *Kane* v. *Chrysler Corporation,* 80 F. Supp. 360, 366 (Del., 1948); *Snyder* v. *Dravo Corporation,* 6 F.R.D. 546, 549 (W.D. Pa., 1947); *Hartman* v. *Time,* 64 F. Supp. 671, 680 (E.D. Pa., 1946). See also the views on liberality of amendment expressed by Judge Browning in *Breier* v. *Northern California Bowling Proprietors' Assn.,* 316 F. 2d 791 (C.A. 9, 1963), wherein the Ninth Circuit declined even to speculate as to whether the amended complaints would be legally sufficient although it reversed the trial court for failure to allow plaintiffs leave to file an amended complaint.

III

The Court of Claims Disregarded the Directions of This Court and the Courts of Appeals That Summary Judgment Is Not Appropriate Where Ultimate Facts Respecting Motive Must Be Made

In 1963, for the second time in a short space of time, this Court, in *White Motor Co.* v. *United States,* 372 U.S. 253, 259, admonished: "Summary judgments . . . as we warned in *Poller* v. *Columbia Broadcasting System,* 368 U.S. 464, 473 . . . are not appropriate 'where motive and intent play leading roles' . . ."

Prior to, and since the *White* and *Poller* decisions, supra, the Courts of Appeals have been sounding the same warning. For example, in *Cross* v. *United States,* 336 F. 2d 431, 433 (C.A. 2, 1964), the Second Circuit stated: ". . . Summary judgment is particularly inappropriate where 'the inferences which the parties seek to have drawn deal with questions of motive, intent and subjective feelings and reactions.' *Empire Electronics Co.* v. *United States,* 311 F. 2d 175, 180 (2d Cir. 1962); See *Alabama Great So. R.R.* v. *Louisville & Nashville R.R.,* 224 F. 2d 1, 5 (5th Cir. 1955); *Subin* v. *Goldsmith,* 244 F. 2d 753, 758 (2d Cir. 1955) . . ."

Despite the admonitions of this Court, the Court of Claims granted summary judgment for the Government here even though all four of the asserted alternative theories of recovery turn upon ultimate findings

of fact respecting motive and intent.[12] Thus, the Court of Claims deprived Petitioners of their right to put on testimony and introduce evidence with respect to such motive and intent.

---

[12] R. 303; Petitioners' claim that they are entitled to a deduction for a loss resulting from a transaction entered into for profit (R. 154-160) is predicated upon an ultimate finding of fact being made that Karl F. Knetsch, at the time he entered into the transaction, did have the profit making motive or purpose required by Section 165 (c) which the Court of Claims acknowledged has always been construed "in terms of the taxpayer's state of mind" (subjective intent).

Petitioners' second, and alternative theory of recovery (R. 160-161) that they were entitled to a deduction for the net out-of-pocket expense paid for the management, conservation or maintenance of property held for the production of income was likewise dependent upon an ultimate finding of fact being made respecting Knetsch's motive or purpose upon entering the transaction.

Petitioners' third, and alternative theory of recovery (R. 125-146) that the refusal of the Commissioner of Internal Revenue to allow them a deduction for their out-of-pocket loss constituted prejudicial discrimination was also based upon an ultimate finding being made respecting what the Commissioner's spokesman, Mr. Harold T. Swartz, intended when he told Congress that taxpayers who had relied on publicized private Internal Revenue Service rulings when they purchased similar annuities were being allowed "a deduction to the extent of the net out-of-pocket expense".

Petitioners' fourth, and alternative theory of recovery also turned on the intent of Mr. Swartz. That theory is that under the doctrine of equitable estoppel (as formulated by the Court of Claims) (R. 147-154), the Commissioner of Internal Revenue should be estopped from repudiating his declaration to Congress that taxpayers like Knetsch were being allowed a deduction for their net out-of-pocket expense.

IV

The Court of Claims Acted in Conflict With the Decisions of the Courts of Appeals by Drawing Fact Inferences as to Purpose and Intention on a Motion for Summary Judgment

In *Gray Tool Co.* v. *Humble Oil & Refining Co.*, 186 F. 2d 365, 367 (C.A. 5, 1951), certiorari denied 341 U.S. 934, the Fifth Circuit said: ". . . A judge may not, on a motion for summary judgment, draw fact inferences as to plaintiff's purposes or intention . . ." This principle has been re-asserted and followed by both the Second and Third Circuits. *Cross* v. *United States*, 336 F. 2d 431, 433 (C.A. 2, 1964); *Bragen* v. *Hudson County News Co.*, 278 F. 2d 615, 618 (C.A. 3, 1960).

Yet acting in disregard of this rule the Court of Claims drew repeated fact inferences respecting purpose and intention. For instance, with regard to Petitioner Knetsch's motive, it stated:

> "In the instant situation, two possible motives or intent *can be ascribed to* these taxpayers when they purchased the annuity contracts. It *appears* that the dominant intent or motive here was the tax advantage sought to be derived from the deductibility of interest. A secondary purpose *would be* that the taxpayers in purchasing these annuity contracts intended to provide for retirement income . . .
>
> We turn now to the question whether *these two types* of 'profit' motives are the profit seeking activities which Section 165(c)(2) requires . . ."[18]

Although the above quotation from the Court of Claims opinion may sound as though it were a theo-

[18] Opinion, App. A, *infra*, pp. 6a-7a. (Emphasis supplied).

retical analysis of a hypothetical case, it is nevertheless the language supporting the judgment in this case which involves present issues and live taxpayers whose subjective state of mind the Court of Claims felt at liberty to draw inferences about on a motion for summary judgment. The Court of Claims made no findings with regard to the Petitioner Knetsch's motives or intent, and indeed could not have done so either as a matter of law[14] or on the state of the record.

In addition the Court of Claims drew fact inferences respecting the intention of Harold T. Swartz who made the statement of Internal Revenue policy to the Congress on which the Petitioners rely. This is shown by the statement of the Court of Claims that:

> "If a policy or practice may be *inferred* from the testimony from the testimony of Mr. Swartz, it seems clear that taxpayers do not fit within such policy and a denial of their claim does not constitute unlawful and prejudicial discrimination."[15] (Emphasis supplied)

The Court of Claims then proceeded to draw an inference respecting what Mr. Swartz intended and on the strength of *that* factual inference, ruled that the factual basis of Petitioners' prejudicial discrimination

---

[14] ". . . The duty of the court on such a motion is not to resolve genuine issues of fact, but to determine if such issues are present . . ." Garcia v. United States, 108 F. Supp. 608, 613 (Ct. Cls., 1952).

[15] Opinion, App. A, infra, p. 15a.

contention had not been proved[16] and granted the Government's motion for summary judgment. The drawing of such inferences not only conflicts with the decisions of the Courts of Appeals set forth above, but it is a deprivation of procedural due process to Petitioners in view of the Court of Claims' earlier ruling prohibiting them from taking the deposition of Mr. Swartz so that they would have an opportunity to produce testimony or other evidence respecting what Mr. Swartz intended.[17] Here the Court of Claims not only drew inferences regarding Mr. Swartz' statement. In effect it testified for Mr. Swartz without affording any opportunity for cross-examination to the Peti-

---

[16] The Government has conceded that the Court of Claims' ruling granting its motion for summary judgment was founded on a fact determination. See footnote 8 of Petition for Writ of Certiorari filed on December 13, 1965, by the Solicitor General in United States v. International Business Machines Corporation, No. 820, October Term, 1965 which states:

"In Knetsch v. United States, 348 F. 2d 932 (Ct. Cl.) taxpayers who had not requested rulings argued that the Court of Claims' 'doctrine of equality of treatment' required the Commissioner to give them a refund because it had given refunds to other similarly situated taxpayers. Although the court stated that its IBM decision 'was based on the court's evaluation of the particular circumstances in that case' (p. 940, fn. 14), it denied the taxpayers' claims *on the ground* that the treatment they sought had not *in fact* been afforded other taxpayers (p. 940). The court *declined to decide* whether, if the taxpayers had been treated unequally, it would have applied the IBM rationale despite the fact that neither the taxpayers in question nor the taxpayers who had allegedly received more favorable treatment had requested or obtained rulings." (Emphasis supplied)

[17] Depositions in the Court of Claims may be taken only upon leave of the court. Rule 30, Rules of the U.S. Court of Claims (Revised April 1, 1964).

tioners. In *Sartor* v. *Arkansas Gas Corp.*, 321 U.S. 620, 628, this Court said:

> ". . . It may well be that the weight of the evidence would be found on a trial to be with defendant. *But it may not withdraw those witnesses from cross-examination,* the best method yet devised for testing untrustworthiness of testimony. And their credibility and the weight to be given to their opinions is to be determined after trial, in the regular manner . . ." (Emphasis supplied)

In short, it is a denial of due process for the Court of Claims to prohibit Petitioners from taking the deposition of Mr. Swartz, and then ruling against them on a motion for summary judgment on the basis of an assumption or inference as to what he might have testified had he been subjected to cross-examination under oath.[18] That is no different than telling a Negro citizen that he cannot go to a decent school, but must prove his ability to read and write well in order to vote.

Furthermore, even if this case were one where motive and intention were not involved, and the basic evidentiary facts were undisputed so that the Court of Claims could draw inferences for the purpose of finding ultimate facts, this Court would still condemn the action of the Court of Claims. In *United States* v. *Diebold,* 369 U.S. 654, 655, the rule is stated that

---

[18] The Third Circuit has not only made the observation that "courts should not for the purpose of expeditious disposition of motions for summary judgments 'shortcut' such (trial) proceedings by 'assuming' factual situations . . .", but has also concluded that "short-cuts" via judicial 'assumptions' provide too many pitfalls to countenance sanction." Krieger v. Ownership Corporation, 270 F. 2d 265, 270 (C.A. 3, 1959).

viewing the facts in the light most favorable to the party opposing the motion, if "inferences contrary to those drawn by the trial court might be permissible," a genuine issue of ultimate fact is thus raised and it is improper for the trial court to grant a motion for summary judgment. That is, even if there were no dispute as to the evidentiary facts herein, if reasonable minds could, nevertheless, draw opposing inferences as to the motive or intention of Petitioner Karl F. Knetsch and Mr. Swartz, the case is not one for disposition by summary judgment, but for trial and findings. *United States* v. *Dollar,* 196 F. 2d 551, 552 (C.A. 9, 1952).

V

The Court of Claims Acted in Conflict With the Decisions of This Court and With Those of the Courts of Appeals By Granting Summary Judgment Herein Where There Exist Genuine Issues of Material Fact

Summary judgment can only be granted "where it is quite clear what the truth is . . . [and where] no genuine issue remains for trial . . ." *Poller* v. *Columbia Broadcasting System, Inc.,* 368 U.S. 464, 472-473; *Sartor* v. *Arkansas Gas Corp.,* 321 U.S. 620, 627.[19] "The burden of showing the absence of a genuine issue of material fact which would justify granting summary judgment is upon the party asking for summary judgment . . ." *Assets Service Corporation* v. *United States,* 121 Ct. Cls. 308, 312 (1952); *Joseph Horne*

[19] Rule 64 (d) of the Rules of the Court of Claims pertaining to summary judgment provides: ". . . The judgment sought shall be rendered if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law . . ."

Co. v. *United States,* 135 F. Supp. 549, 551 (Ct. Cls., 1955). In its Answer (R. 11-14) the Government denied virtually all of the factual allegations contained in the Petition (R. 1-10), and thus raised genuine issues of material fact. When it later made its motion for summary judgment, the Government attempted to carry its burden of showing that there was no genuine issue of material fact by simply stating therein that: "Solely for purposes of this motion the allegations of well-pleaded facts are taken as true."[20] But that statement does not meet the burden which was placed on the Government. Nor does it resolve or eliminate the issues of material fact raised by the pleadings. It is only where there are actually no remaining genuine issues of material fact that summary judgment can be granted. And it is implicit in the Government's statement that "Solely for purposes of this motion the allegations of well-pleaded facts are taken as true" that there are genuine issues of material fact present. Otherwise, there would have been no need for the Government to attach such a qualification to its motion.

Also, the presence of genuine issues of material fact in this case is clearly reflected by the opinion of the Court of Claims. First, there is no statement in the thirteen page opinion granting the Government summary judgment that "there is no genuine issue of material fact." The absence of such a finding or recital is significant in determining whether the Court of

[20] If condoned, such a practice by Government trial lawyers would, no doubt, soon become even more popular because they have everything to gain and nothing to lose. If summary judgment is granted, they have a judgment on the merits. If summary judgment is denied, they have admitted nothing and can still force the plaintiff to his proof.

Claims should have granted the Government's motion for summary judgment. *United States* v. *Western Electric Co.*, 337 F. 2d 568, 572 (C.A. 9, 1964). Second, the repeated drawing of factual inferences by the Court of Claims, as shown in Point IV, *supra*, shows the presence of unresolved factual disputes. If there had been no dispute as to such facts, the Court of Claims would not have had to draw inferences. Instead it would merely have stated the undisputed fact, and applied the law thereto.

Furthermore, and as shown in Point IV, even if there were no dispute here as to the underlying evidentiary facts and it would have otherwise been proper for the Court of Claims to draw inferences therefrom, if viewing such underlying evidentiary facts in the light most favorable to the party opposing the motion, "inferences contrary to those drawn by the trial court might be permissible", then summary judgment may not be granted. *United States* v. *Diebold*, 396 U.S. 654, 655.

VI

The Government Was Not Entitled to Summary Judgment as a Matter of Law in View of the Decisions of This Court and the Court of Claims

In its motion for summary judgment, the Government conceded that:

> "On January 18, 1957, the Commissioner of Internal Revenue stated to the United States House of Representatives' Subcommittee on Internal Revenue Taxation, in formal hearings before that Subcommittee, that, while interest deductions claimed in regard to annuity transactions were being denied taxpayers who claimed same, the Internal Revenue Service, was, as a matter of

> policy, allowing such taxpayers a deduction for their net out-of-pocket *loss* realized from such annuity transactions where the taxpayer had acted in reliance on references in trade magazines and the tax services to the issuance of private rulings by the Treasury Department stating that interest paid in connection with such annuity transactions was deductible for income tax purposes." (R. 7, 18).

The Government, in like fashion, also conceded that Petitioner Karl F. Knetsch had purchased annuity contracts while acting in reliance upon such publicized private Treasury rulings stating that interest paid in connection with such annuity transactions was deductible for income tax purposes, that he had been denied interest deductions claimed with regard thereto, and that he had realized a net out-of-pocket loss from such annuity transaction in the amount of $137,315. (R. 2-9).

As a matter of law, upon such conceded facts, the Petitioners were entitled to recover under the principle that *taxpayers similarly situated should be accorded equal treatment. Dixon* v. *United States,* 381 U.S. 68, 77; *United States* v. *Kaiser,* 363 U.S. 299, 308 (concurring opinion). See also *International Business Machines Corp.* v. *United States,* 343 F. 2d 914 (Ct. Cls., 1965) (Petition for Writ of Certiorari filed by Solicitor General on December 13, 1965, No. 820, October Term, 1965); *Exchange Parts Co. of Fort Worth* v. *United States,* 150 Ct. Cl. 538, 279 F. 2d 251 (Ct. Cls., 1960), cert. not requested by the Government, 1961 P-H Excise & Tax Serv. 195, 314; *City Loan & Savings Co.* v. *United States,* 177 F. Supp. 843 (D.C. Ohio, 1959), aff'd 287 F. 2d 612 (C.A. 6th Cir.);

Brecklein v. *Bookwalter,* 231 F. Supp. 404, 411 (D.C. Mo., 1964) (on appeal to C.A. 8th Cir.); *Connecticut Railway & Lighting Co.* v. *United States,* 135 Ct. Cl. 650, 654, 142 F. Supp. 907, 909 (Ct. Cls., 1956).

Thus, for the Court of Claims to conclude, in the face of such facts conceded by the Government, that the Petitioners were not entitled to relief constitutes a refusal to follow the above decisions of this Court, and a refusal to apply its own decisions to the Petitoners as it did to International Business Machines Corporation on April 16, 1965, three months before the decision herein.

Also, on the basis of such conceded facts, the Petitioners were entitled, as a matter of law, to relief under the doctrine of equitable estoppel as announced by the Court of Claims. That doctrine is one which has been repeatedly invoked "to prevent a wrong being done 'wherever, in good conscience and honest dealing', a party ought not to be permitted to repudiate his previous statements and declarations." *Mahoning Inv. Co.* v. *United States,* 78 Ct. Cl. 231, 248, 3 F. Supp. 622, 630 (1930), cert. denied 291 U.S. 675 (1934) is the leading case.[21] This doctrine of *equitable* estoppel must be distinquished from the ordinary doctrine of estoppel because, as the Court of Claims held in *Branch Banking & Trust Co., et al.* v. *United States,* 120 Ct. Cl. 72, 91-92, 98 F. Supp. 757, 768 (1951), detrimental reliance is not an essential ingredient of equitable estoppel. Here an application of the doctrine of equitable estoppel requires a conclusion that the refusal of the Commissioner of Internal Revenue to allow Peti-

[21] A long line of Court of Claims' cases dealing with this doctrine are collected at R. 147-152.

tioners a deduction for the net out-of-pocket loss suffered by them in the circumstances of this case[22] is an unjustifiable repudiation of his previous statements and declarations to Congress which in good conscience ought not to be permitted.

Third, in the course of reaching the conclusion that, as a matter of law, the Petitioners were not entitled to a loss deduction under Section 165(c)(2) of the Internal Revenue Code of 1954,[23] the Court of Claims not only failed to apply the well-established rule that the statutory requisite of profit-making motive or intention is construed in terms of the taxpayer's state of mind[24] (although it acknowledged the existence of such a rule),[25] but it went on to fashion and apply a new rule of law—namely, that the taxpayer's profit intention is to be determined from *objective* factors. This newly-formulated test is in direct conflict with

---

[22] The Commissioner of Internal Revenue not only issued rulings which held that interest paid in connection with such annuity transactions was deductible (which rulings the Treasury admitted to the Congress it knew had been publicized), on the strength of which Petitioner Karl F. Knetsch purchased his annuities, but the Commissioner thereafter declared to Congress that where taxpayers had acted in reliance on such rulings issued to other taxpayers but publicized, such taxpayers were being allowed a net out-of-pocket loss.

[23] Since the Court of Claims concluded that Petitioners were not entitled to a claimed loss under Section 212 (2) because of an absence of profit-making motive, this portion of Petitioners' reasons for granting certiorari apply to that ruling as well, although the references in the text are limited to the Court of Claims' ruling on the Section 165 (c)(2) loss issue.

[24] Weir v. Commissioner, 109 F. 2d 996, 997 (C.A. 3, 1940), cert. denied 310 U.S. 367 (1940), is the leading case.

[25] R. 304.

long established decisions which have held that the profit making motive and intention of the taxpayer is a matter of subjective intent, and such test will have a far-reaching impact on a host of pending tax cases should it not be reviewed.

At the same time the Court of Claims fashioned and applied another rule of law which is also wrong and constitutes a serious misreading of *Gregory* v. *Helvering*, 293 U.S. 465. That new rule is: "there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been 'without economic substance' or a 'sham'." (R. 306). The new rule was based on the following reasoning:

> ". . . The doctrine of *Gregory* v. *Helvering*. 293 U.S. 465 (1935) requires that:
>
> > * * * in construing words of a tax statute *which describe commercial* or *industrial* transactions, we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered into for no other motive but to escape taxation.
>
> Therefore, the statutory word 'profit' cannot embrace profit seeking activity in which the only economic gain derived therefrom results from a tax reduction. In other words, there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been 'without economic substance' or a 'sham'." (Emphasis supplied)

However, the Court of Claims has offered no explanation in its opinion as to how or why a doctrine adopted and used "in construing words of a tax statute *which*

describe commercial or *industrial* transactions" is or should be relevant or applicable to a subsection of the Internal Revenue Code which deals *exclusively* with *non-trade* or *non-business* losses, that is, losses which result from transactions which are neither commercial nor industrial transactions.[26] Should this new rule not be reviewed, it will have a far-reaching impact on pending tax cases.

The effect of the Court of Claims' decision is punitive in nature, and dictates that taxpayers who have engaged in transactions authorized by Treasury rulings but later classified with the negative label "sham" are to be denied loss deductions which the statute permits. It is more than incongruous that the Treasury Department can be permitted to issue such rulings to persons writing on the letterheads of insurance companies, collect income tax from the insurance companies on the amounts paid to such companies as interest, deny an interest deduction to such taxpayers and collect the full amount of income tax from them as if they had never entered the annuity transactions, and *then* have the Court of Claims approve the Treasury's denial to such taxpayer of a loss resulting from such transaction even though such allowance would never make the taxpayer whole and even though the Commissioner of Internal Revenue had represented to the Congress that he was in fact allowing such losses. There is something seriously wrong and unjust about a series of policies and affirmations thereof by the Court of Claims which allows the Commissioner

---

[26] Section 165 (c)(2), Internal Revenue Code of 1954 refers to: "(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business."

of Internal Revenue to "arm" insurance agents with letter rulings which are used to induce taxpayers to enter into such annuity transactions, make a profit from the tax collected from the insurance company's receipt of interest income, and then not honor his word to the Congress that he would undo some of the economic damage to the taxpayers by allowing them a loss for their net out-of-pocket loss. Here the taxpayer has already been punished in the sum of $137,315 as a result of the Commissioner's rulings, and the refund sought herein would only recoup $85,508.92 of that damage which was caused by the Commissioner's rulings.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted.

WILLIAM LEE MCLANE
NOLA MCLANE
THADDEUS ROJEK
2101 Connecticut Avenue, N.W.
Washington, D. C.

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS

No. 323-62

(Decided July 16, 1965)

KARL F. KNETSCH AND EVA FAY KNETSCH

v.

THE UNITED STATES

Before LARAMORE, DURFEE, DAVIS and COLLINS, *Judges*, and WHITAKER, *Senior Judge*.

ON DEFENDANT'S AND PLAINTIFFS' MOTIONS FOR SUMMARY JUDGMENT

LARAMORE, *Judge*, delivered the opinion of the court:

In 1960, the Supreme Court in *Knetsch* v. *United States*, 364 U.S. 361, put an end to one more of the growing number of "tax saving schemes"[1] which are designed to lure high income bracket taxpayers with the promise of substantial tax savings at a relatively small out-of-pocket cost.

---

[1] For other similar tax saving schemes see *Eli O. Goodstein*, 30 T.C. 1178, affirmed on other grounds, 267 F. 2d 127 (1st Cir. 1959); *MacRae* v. *Commissioner*, 294 F. 2d 56 (9th Cir. 1961); *Kaye* v. *Commissioner*, 287 F. 2d 40 (9th Cir. 1960); *Gerstell* v. *Commissioner*, 319 F. 2d 131 (3d Cir. 1963); *Lewis* v. *Commissioner*, 328 F. 2d 634 (7th Cir. 1964); *Dooley* v. *Commissioner*, 332 F. 2d 463 (7th Cir. 1964); *Jockmus* v. *United States*, 335 F. 2d 23 (2d Cir. 1964). All these cases involve unsuccessful efforts to simulate borrowings and payment of interest. See also *Malden Knitting Mills*, 42 T.C. 769 (1964); *Empire Press, Inc.*, 35 T.C. 136 (1960); *Gold*, 41 T.C. 419 (1963); *Cahn*, 41 T.C. 858 (1964) involving purchase and short sale of phantom shares.

The case at bar presents another facet of the same transaction, involving the same taxpayers in which they seek to effectuate a tax recovery of their out-of-pocket losses in the year the unsuccessful scheme was abandoned. In this instance, a number of insurance companies put forth a plan for selling annuity contracts based on the tax advantage derived from the omission of annuities from the treatment accorded single-premium life insurance or endowment contracts. Under the plan devised, the annuity was "sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity" and "interest on the loan (which may be a non-recourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity."[2] This was made possible because the Federal income tax laws, as enacted by Congress prior to 1954, did not disallow, as it did in the case of single-premium life insurance or endowment contracts, the interest purportedly paid to purchase or carry single-premium annuity contracts.[3]

The prospective purchasers, in this instance Mr. Knetsch, would be shown private letter rulings, which had been

---

[2] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 38 (1954).

[3] Congress, in 1942, first denied a deduction for amounts paid on indebtedness incurred to purchase single-premium life insurance and endowment contracts (§ 129 of the Revenue Act of 1942, 56 Stat. 798, 827, amending § 24(a) of the Internal Revenue Code of 1939. This provision was enacted "to close a loophole" in our tax laws. See Hearings before Senate Finance Committee on H.R. 7378, 77th Cong., 2d Sess., p. 54. Prior acts did not specifically deny the deduction; e.g., § 23(b) of the Revenue Act of 1934, 48 Stat. 680, 688; § 23(b) of the Revenue Act of 1936, 49 Stat. 1648, 1659; § 23(b) of the Revenue Act of 1938, 52 Stat. 447, 460; § 23(b) of the Revenue Act of 1939, 53 Stat. 1, 12.

secured by an officer of the insurance company, indicating that in the purchase of an annuity contract identical to the one offered, the interest payments would be deductible under section 23(b) of the Internal Revenue Code of 1939. These taxpayers, unsophisticated in the complexities of our tax laws, would enter into these transactions with the belief that the deductibility of the interest charges would never be questioned by the Internal Revenue Service.

Congress became aware of this scheme, and in 1954 enacted section 264(a)(2) of the Internal Revenue Code of 1954 which closed this loophole in our tax laws by denying the deductibility of the interest charges in the purchase of single-premium annuity contracts. However, the denial of the interest deduction applied to annuity contracts purchased after March 1, 1954.

On March 17, 1954, the Commissioner of Internal Revenue issued Revenue Ruling 54-94[4] which revoked prior issued private rulings and denied the deductibility of interest charges for *all* annuity contracts, including those acquired on or before March 1, 1954. The basis for the denial, said the Commissioner, was that there was not, in such cases, in substance, any borrowing of money by the annuity purchaser. The Supreme Court, in *Knetsch* v. *United States, supra,* upheld the Commissioner's position. By finding that there was no economic substance to the transaction "beyond a tax deduction" and consequently a "sham," the Court laid to rest the issue whether the amounts paid constituted "interest paid * * * on indebtedness" within the meaning of section 23(b) of the 1939 Code and section 163(a) of the 1954 Code. There remains the question whether these same taxpayers can have a tax recovery on their out-of-pocket costs in the year (1956) when they abandoned this unsuccessful scheme.

---

[4] Rev. Rul. 54-94, 1954-1 Cum. Bull. 53.

In the instant case, the claimed loss is computed as follows:

Amounts paid to the company:			
Cash paid at time of purchase		$4,000	
Interest payments to company—			
1953.....	$143,465		
1954.....	147,105		
1955.....	150,745	441,315	
Total paid to company			$445,315
Less:			
Amounts received from company as loans:			
1953.....	$ 99,000		
1954.....	104,000		
1955.....	104,000	$307,000	
Net cash value upon surrender ..		1,000	
Total received from company			308,000
Net out-of-pocket cash loss			$137,315

In arguing for a tax recovery of the out-of-pocket costs, taxpayers invoke four separate grounds which they claim require us to rule in their favor. They argue that the loss realized in 1956 on the surrender of the annuity contracts is a recognized loss under section 165(c)(2) of the 1954 Code which provides that individuals may deduct losses sustained "in a transaction entered into for profit." Alternatively, they claim that the out-of-pocket expense of $137,315 is deductible as an ordinary and necessary expense paid for the management, conservation or maintenance of property held for the production of income under section 212 of the 1954 Code. Taxpayers further claim that the doctrine of equality of treatment of similarly situated taxpayers requires the allowance to them of the deductions for the out-of-pocket expenses. Finally, the taxpayers argue that the government is equitably estopped from disallowing the out-of-pocket costs. We shall treat each contention separately.

The government does not dispute the fact that taxpayers *realized* a loss in 1956; however, they argue that this loss is not *recognized* by section 165(c)(2) of the 1954 Code. With respect to individuals, in addition to the losses incurred in a trade or business, the Code through section 165 (c)(2) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise if incurred in any transaction entered for profit though not connected with a trade or business.[5]

The government first argues that the "loss" these taxpayers sustained is not a "loss" in the sense in which that term is used in section 165, since a "loss" normally connotes an involuntary result as distinguished from a planned expenditure which is incurred with no hope of a greater return. The government points out that we have required that "[a] loss, in order to be deductible under the statute, must be an unintentional parting with something of value." *Dresser* v. *United States*, 74 Ct. Cl. 55, 77, cert. denied 287 U.S. 635 (1932). From this it argues that when taxpayers made their payments they knew that the payments would be less than their receipts. In other words, the alleged interest payments would be more than the amount that they could borrow back during that year.

We think that such a construction of the term "loss" is too narrow. By only looking at the taxpayers' expendi-

---

[5] Section 165 reads in pertinent part as follows:

"§ 165 Losses.

(a) *General Rule.* There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(c) *Limitation on losses of individuals.* In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *."

tures and receipts from the insurance company, it fails to take into account the economic advantage that would have been derived either from the allowance of the interest deduction or the increase in the cash value of the annuity. In other words, the loss, although measured by subtracting the expenditures from the receipts, was incurred either as a result of the disallowance of the interest deduction, or resulted from the early surrender of the annuity contract. Thus these events are the "unintentional parting with something of value" which we required in *Dresser, supra.*

Although the loss these taxpayers realized is a "loss" within the meaning of section 165, taxpayers fail to meet the second requirement of section 165(c)(2) limiting deductible losses, outside the sphere of the taxpayer's trade or business, to those incurred in "transactions entered into for profit." This limitation first appeared in the Revenue Act of 1916 and it has been construed ever since in terms of taxpayer's state of mind. *Weir* v. *Commissioner,* 109 F. 2d 996, 997 (3d Cir.) cert. denied 310 U.S. 367 (1940). The Supreme Court has said that the determinative question is whether the taxpayer's purpose in entering into the transaction was primarily for profit. *Helvering* v. *Commissioner,* 304 U.S. 282, 289 (1938). There are two crucial words contained in this test: purpose and profit.

The word purpose carries with it not only taxpayer's intent, but also his motive for entering into the transaction. Thus, you can have a profit intention side-by-side with a nonprofit motive. However, the statutory requirement "for profit" can be satisfied by either. *Weir* v. *Commissioner, supra,* at 998. By the same token, you can have a prohibited profit motive or intent side-by-side with a legitimate profit motive or intent and meet the statutory requirement.

In the instant situation, two possible motives or intents can be ascribed to these taxpayers when they purchased

the annuity contracts. It appears that the dominant intent or motive here was the tax advantage sought to be derived from the deductibility of the purported interest. A secondary purpose would be that the taxpayers in purchasing these annuity contracts intended to provide for retirement income. These two purposes are not mutually exclusive and, moreover, would produce two different kinds of "profit." The tax advantage purpose would produce a profit measured by the tax savings secured by the allowance of the purported interest deduction. The other would be measured by the increase in the "net cash" value of the annuity at any given date.

We turn now to the question whether these two types of "profit" motives are the profit seeking activities which section 165(c)(2) requires. The word "profit" for purposes of this section, has been defined as "the advantage or gain resulting from the investment of capital, or the acquisition of money beyond the amount expended; a pecuniary gain." *Goldsborough* v. *Burnet*, 46 F. 2d 432, 433 (4th Cir. 1931). See also *Dupont*, 36 B.T.A. 223 (1937). *Feine* v. *McGowan*, 188 F. 2d 738 (2d Cir. 1951). However, we think that section 165(c)(2) was not designed to be a catch-all provision allowing taxpayers to deduct any out-of-pocket expenditures. The Third Circuit has limited the deduction for losses to transactions which were designed to achieve and intended to secure the production of taxable income.

The court reasoned that:

> * * * the fundamental object of the statute is discernible. As stated by Mr. Justice Stone speaking for an [sic] unanimous court: "Section 214 [now section 165 of the 1954 Code] read as a whole, discloses plainly a general purpose to permit deductions of capital losses wherever the capital investment is used to produce taxable income." *Heiner* v. *Tindle*, 276

> U.S. 582, 585 * * *. See also, *Dresser* v. *United States* [74 Ct. Cl. 55], * * *. In other words, the government says to the taxpayer with shrewd benevolence, "If you intend to benefit us by producing taxable profits, you may take your loss, but if you don't intend to so benefit us, you cannot deduct your losses and we, furthermore will tax you on your windfalls." The benefit of increased revenue is certainly not assured when there is no intention to profit. [*Weir* v. *Commissioner, supra* at 998]

Under this test, the motive to effect a tax reduction cannot produce a transaction entered into for profit in the statutory sense since the profit measured by the tax savings that would be produced if the transaction was successful, would not be taxable income. On the other hand, the intent to use the annuity contract as a means of securing retirement income would be a transaction entered into for profit within the meaning of this section, since under certain circumstances the proceeds paid beyond cost would be taxable income to the recipient. See I.T. 3576, 1942-2 Cum. Bull. 105, as modified by Rev. Rul. 61-201, 1961-2 Cum. Bull. 46, stating that a loss realized upon the surrender or forfeiture of an annuity contract is deductible as an ordinary loss under section 165.

We need not rely solely on the Third Circuit's test in determining that a transaction is not one entered for "profit" in the statutory sense if the only economic gain derived therefrom results from a tax reduction. The doctrine of *Gregory* v. *Helvering*, 293 U.S. 465 (1935) requires that:

> * * * in construing words of a tax statute which describe commercial or industrial transactions, we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to in-

clude transactions entered upon for no other motive but to escape taxation.[6]

Therefore, the statutory word "profit" cannot embrace profit seeking activity in which the only economic gain derived therefrom results from a tax reduction. In other words, there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been "without economic substance" or a "sham."

Taxpayers rely on *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1st Cir. 1959); *Lynch* v. *Commissioner*, 273 F. 2d 867 (2d Cir. 1959). In *Goodstein* the First Circuit was faced with an effort similar to that in *Knetsch* to simulate borrowings and payments of interest. The Tax Court had denied the taxpayer's claimed interest deduction on the ground that the transaction lacked "economic substance" and also denied the taxpayer's alternative claim of a deduction for the loss suffered in the transaction, stating that the said outlay "was paid as a fee * * * for the purpose of obtaining a tax benefit" and as such not deductible.[7] Upon review the First Circuit disagreed with the Tax Court's denial of the claimed loss deduction, although it affirmed the Tax Court's holding that the underlying transaction lacked substance and, therefore, the interest was not deductible. The court was of the view that "the amount actually expended by the taxpayer in connection with a transaction which, although it did not result in the purchase of Treasury notes or the borrowing of money, did create a bilateral contract between * * * [the par-

---

[6] *Commissioner* v. *Transport Trading & Terminal Corp.*, 176 F. 2d 570, 572 (2d Cir. 1949) (Judge Learned Hand writing for the court). See also *Diggs* v. *Commissioner*, 281 F. 2d 326 (2d Cir. 1960).

[7] 30 T.C. 1178, 1192 (1958).

ties].'"[8] However, the court was of the view that the transaction was not completed in the taxable year and, consequently, the expenditure could not be deducted as a loss for that year but rather must be classified as an item of cost to be considered in the taxable year when the transaction was finally completed.[9] The Second Circuit, in *Lynch* v. *Commissioner*,[10] has indicated its agreement with this conclusion. It appears that the rationale of these two cases is that expenses, although incurred in connection with transactions which had been entered into solely for the purpose of avoiding tax, are deductible if the expenditure gives rise to a contractual obligation, which if carried out would give rise to a profit or a loss. These cases have been criticized by the Seventh Circuit in *Lewis* v. *Commissioner*,[11] on the grounds that they overlook the fact that the contractual obligation (the option contracts) as well as the interest payments, were shams. We think that the reasoning in *Goodstein* is correct if the reviewing court is not faced with the factual determination that the contractual obligation was *not* itself a sham. The Tax Court in *Fabreeka Products Co.*[12] has implicitly noted this distinction and held that *bona fide* expenses incurred in connection with transactions which had been entered solely for the purpose of avoiding tax, are deductible. The court reasoned that:

> * * * [t]he substance versus form rule requires us to treat the totality of steps as the declaration and payment of a nondeductible dividend, but in the course of unsuccessfully attempting to convert it into deduct-

---

[8] 267 F. 2d at 131-132.

[9] *Ibid.*

[10] 273 F. 2d 867, 872 (2d Cir. 1959).

[11] 328 F. 2d 634 (7th Cir. 1964).

[12] 34 T.C. 290 (1960); see also *Jack Sherman*, 34 T.C. 303 (1960).

> ible amortization petitioner did actually incur expenses which, standing alone, must be allowed as deductions. Thus, it seems clear that the taxpayer in *Gregory* v. *Helvering,* 293 U.S. 465, would not have been denied a deduction for legal fees merely because the course of the action advised by the lawyer backfired. True, the transaction in the *Gregory* case failed to qualify as a "reorganization" because of lack of business purpose, but this doesn't mean that the component steps are to be completely ignored for all purposes. * * * Petitioner in the instant case actually borrowed money and is entitled to deduct the interest paid thereon. * * * We know of no rule of law applicable here that is comparable to the "public policy" rule in the case of expenses relating to illegal acts.

We think that the reasoning of *Fabreeka Products* is valid since the deductible expenditures for interest, stamp taxes, legal and accounting fees *were real,* although the overall transaction was considered a sham. The *Goodstein* and *Lynch* cases are an extension of this principle since the contracts there gave the taxpayer the right to buy Treasury notes, which could still be exercised, and until completed there could still be a possibility of gain or loss. However, they are dependent on a finding that these contractual rights were not "shams."

The same reasoning can apply to the instant situation; *i.e.,* in order for the realized loss to be recognized under section 165(c)(2), the permissive profit motive previously discussed is required. Thus taxpayers here are required to show that they intended, when they purchased their annuity contract, to realize a profit through the increase in the cash value of the annuity contract apart from the tax savings.

It appears that the taxpayers' only motivating factor was the tax deduction. The findings by the trial court in

the original *Knetsch* case reflects this, 361 U.S. at 364-365. It is immaterial that the Supreme Court in reaching its decision set the motive factor aside. It was not a necessary factor for its decision. However, this does not mean that the finding in any way has lost its validity. Moreover, that these taxpayers did not intend to use the profit feature of these annuities is apparent from the fact that their equity in this annuity contract was never more than a nominal amount, "because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000.00." 361 U.S. at 366. This conclusion is also reflected by the Supreme Court's statement that "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." Taxpayers argue as evidence of the permissive profit motive that in ten years the net cash value of the bonds would have exceeded the amounts paid as interest. This contention, however, as the Supreme Court recognized, "is predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 'loan'." 364 U.S. at 366, footnote 3. Thus, the objective facts in this case, which can be used as indicators of the taxpayers profit intention, show that they never intended to realize a profit on the transaction separate and apart from the tax benefits they hoped to derive therefrom. Under such circumstances, we hold that the loss taxpayers realized is not recognized as a loss incurred in a transaction entered for profit within the meaning of section 165(c)(2).

Taxpayers argue that it was necessary for them to make the so-called interest payments in order to preserve their rights under the annuity contracts, which might otherwise be cancelled. From this premise they conclude that the out-of-pocket expense of $137,315 is deductible as an ordinary and necessary expense paid for the management,

conservation or maintenance of property held for the production of income under section 212(2) of the 1954 Code. Deductions under section 212(2) of the Internal Revenue Code of 1954 depend upon whether the expenditures arise "in connection with the taxpayer's profit-seeking activities." *United States* v. *Gilmore*, 372 U.S. 39, 48 (1963). Since we have determined that taxpayers' "profit" motives are not the profit seeking activities contemplated by the statute under section 165(c)(2), the same will be true with respect to section 212. Therefore, taxpayers are not entitled to a deduction under section 212 for their net out-of-pocket expenses.

As a basis for their estoppel argument, taxpayers claim that the Commissioner of Internal Revenue stated before a subcommittee of the House of Representatives on January 18, 1957, that individuals would be allowed their out-of-pocket expenditures in transactions of the Knetsch type where they have relied on private rulings issued to others.

Taxpayers recognize that they may not properly rely on the private rulings issued to other individuals as a basis for estoppel as to them. *E.g., Bornstein* v. *United States*, Ct. Cl. No. 270-61, decided May 14, 1965; *Minchin* v. *Commissioner*, 335 F. 2d 30 (2d Cir. 1964) and cases cited therein. However, they urge that the answers to questions by a Revenue Service official before a congressional committee in 1957 results in an estoppel in their favor and against the government.[13] Assuming that such statements covered taxpayers case, they were uttered from two to four years after taxpayers had spent the out-of-pocket moneys for which they now seek deductions. We have recently stated that "[d]etrimental reliance is an essential ingredient of estoppel." *Bornstein* v. *United States, supra,*

---

[13] Progress Report of the Subcommittee on Internal Revenue Taxation to the Committee on Ways and Means, April 22, 1957, at page 192 (hereinafter referred to as Progress Report).

slip op., p. 7. Taxpayers argue that the necessary reliance took place on January 4, 1961 when they paid the tax due resulting from the disallowance by the Commissioner of the claimed out-of-pocket loss for 1956. There is no merit to taxpayers' contention since it is irrelevant that they paid the amount of the proposed deficiency in 1961 in alleged reliance on those statements. Payment of the proposed deficiency was no more than a prerequisite to jurisdiction in a forum other than the Tax Court. Therefore, we conclude there is no factual basis for estopping the government in favor of taxpayers.

Taxpayers' final contention is that the doctrine of equality of treatment requires the allowance to them of deductions for the net out-of-pocket loss realized in the transaction. Insofar as taxpayers' contention is that there is prejudicial discrimination because of a difference in treatment in favor of those who received and relied upon private rulings issued to them as against the instant taxpayers who neither applied for, nor received, a ruling of their own but relied solely on the private ruling issued to other taxpayers, we think there is no merit to such a contention. The same argument has been made by a number of other taxpayers who engaged in the same kind of annuity scheme and has been uniformly rejected by the courts. *Weller* v. *Commissioner,* 270 F. 2d 294 (3d Cir. 1959); *Gerstell* v. *Commissioner,* 319 F. 2d 131 (3d Cir. 1963); *Carpenter* v. *Commissioner,* 322 F. 2d 733 (3d Cir. 1963); *Minchin* v. *Commissioner,* 335 F. 2d 30 (2d Cir. 1964). The same argument has been recently rejected by the Supreme Court in *Dixon* v. *United States,* —— U.S. ——, decided May 3, 1965, slip op., pp. 4-8. We also rejected it in our decision in *Bornstein* v. *United States, supra.*[14]

[14] As the court pointed out in *Bornstein, supra,* our decision in *International Business Machines Corp.* v. *United States,* Ct. Cl. No. 36-61, decided April 16, 1965, 343 F. 2d 914, rested in section 7805(b) of the Internal Revenue Code, of 1954, and was based on the court's evaluation of the particular circumstances in that case.

Taxpayers' remaining basis for their claim of prejudicial discrimination is that other taxpayers who did not apply for or receive rulings, but who relied to their detriment upon rulings issued to others, were allowed to deduct their out-of-pocket costs. Taxpayers' factual basis for their claim is a statement made by Revenue Service official Harold T. Swartz in 1957 at a hearing before a congressional committee. We quote the relevant part of this testimony:

> With reference to the nonretroactive application denying the interest deduction to people who relied on our private rulings, we were uniform in applying it nonretroactively to the extent we felt they had relied upon it to their detriment. In other words, we would allow them a deduction for the out-of-pocket money they had spent, not the full interest deduction, but the extent to which they had relied on it to their detriment. Our statement of policy with reference to nonretroactive application of a ruling is only where the taxpayer had relied on it, and only to the extent he relied on it to his detriment and was out of pocket. We allowed a deduction to the extent of the net out-of-pocket expense. [Progress Report, supra, p. 197]

If a policy or practice may be inferred from the testimony of Mr. Swartz, it seems clear that taxpayers do not fit within such policy and a denial of their claim does not constitute unlawful and prejudicial discrimination.

Taxpayers are not seeking net out-of-pocket interest deductions for the year when paid, but they are seeking out-of-pocket loss on the cancellation of their annuity in 1956. But nothing in the policy statement taxpayers rely on authorizes this, and taxpayers have not shown that any other taxpayer has been allowed a deduction for out-of-pocket cost or loss on the cancellation of the annuity contract similar to the one here in issue.

Mr. Swartz did not testify that it was the policy of the service to allow deduction of a loss on cancellation of the annuity. His testimony was that under the appropriate circumstances to which he referred, the Service would allow a deduction for part of the interest claimed. Under such circumstances, we hold there was no discrimination with respect to these taxpayers. Therefore, we need not reach the question of taxpayers' right of recovery if they had proved discrimination. *Cf., International Business Machines Corp.* v. *United States, supra; Exchange Parts Co.* v. *United States,* 150 Ct. Cl. 538, 279 F. 2d 251 (1960); *Connecticut Ry. & Lighting Co.* v. *United States,* 135 Ct. Cl. 650, 142 F. Supp. 907 (1956).

For the foregoing reasons, plaintiffs are not entitled to recover. Defendant's motion for summary judgment is granted; plaintiffs' motion for summary judgment is denied, and the petition is dismissed.

APPENDIX B

Statutes Involved

Internal Revenue Code of 1954:

SEC. 165. LOSSES.

(a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(c) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

* * * * *

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * * * *

(2) for the management, conservation, or maintenance of property held for the production of income,

* * * * *

RULES OF THE UNITED STATES COURT OF CLAIMS:

RULE 22. AMENDED AND SUPPLEMENTAL PLEADINGS

(a) *Amendments:* A party may amend his pleading once as a matter of course at any time before the service on him of a responsive pleading or of a motion to dismiss or for summary judgment, or, if the pleading is one to which no responsive pleading is permitted, he may so amend it at

any time within 30 days after it is served. Otherwise, a party may amend his pleading (1) by leave of court* (which shall be freely given when justice so requires) * * *

RULE 30. DEPOSITIONS: LEAVE; SCOPE

(a) *Leave Required:* Depositions may be taken only by leave of the court* as provided in this rule.

RULE 64. SUMMARY JUDGMENT.

* * * * *

(d) *Motion and Proceedings Thereon:* After a motion for summary judgment has been filed in conformity with Rule 11 and has been served as provided in Rule 7, and after expiration of the time allowed by Rule 12(b) for filing a response thereto, such motion shall (subject to the provisions of Rules 54(b) and 65(b) (2)) be assigned to the calendar. The judgment sought shall be rendered if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.

* Or the commissioner: Rule 4.

INDEX

	Page
Opinion below	1
Jurisdiction	1
Questions presented	2
Statutes involved	2
Statement	3
Argument	5
Conclusion	11

CITATIONS

Cases:

Automobile Club v. *Commissioner*, 353 U.S. 180	11
Bookwalter v. *Brecklein* (C.A. 8), decided March 1, 1966	11
Commissioner v. *Sunnen*, 333 U.S. 591	6
Dixon v. *United States*, 381 U.S. 68	10, 11
Foman v. *Davis*, 371 U.S. 178	6
Gerstell v. *Commissioner*, 319 F. 2d 131, certiorari denied, 375 U.S. 941	6
Gregory v. *Helvering*, 293 U.S. 465	6
International Business Machines Corp. v. *United States*, 343 F. 2d 914, certiorari denied, January 31, 1966	10
Juniper Investment Co. v. *United States*, 338 F. 2d 356	9
Kinsley v. *Markovic*, 333 F. 2d 684	6
Knetsch v. *United States*, 364 U.S. 361	3, 4, 5
Real Estate Title Co. v. *United States*, 309 U.S. 13	7
United States v. *Garbutt Oil Co.*, 302 U.S. 528	7
United States v. *Gilmore*, 372 U.S. 39	6
United States v. *Kaiser*, 363 U.S. 299	10

Statutes:

Internal Revenue Code of 1954:	
Sec. 165, 26 U.S.C. 165	2
Sec. 165(c), 26 U.S.C. 165(c)	5

Statute—Continued Page

Sec. 212, 26 U.S.C. 212 3
Sec. 212(2), 26 U.S.C. 212(2) 5, 6
Sec. 6511, 26 U.S.C. 6511 7
Sec. 7805(b), 26 U.S.C. 7805(b) 10

Miscellaneous:

Rev. Rul. 54-59, 1954-1 Cum. Bull. 53 10

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. 1a-16a) is reported at 348 F. 2d 932.

JURISDICTION

The judgment of the Court of Claims was entered on July 16, 1965 (Pet. 1a, 16a), and petitioner's [1] motion for rehearing was denied on October 15, 1965.

---

[1] Mrs. Knetsch is a party solely because she and her husband filed a joint income tax return for the year here in question. We refer to Mr. Knetsch as "petitioner."

By order dated January 13, 1966, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 17, 1966. The petition for a writ of certiorari was filed on January 17, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether the Court of Claims correctly held that petitioner's costs of a sham transaction were not deductible either as a loss on a transaction entered into for profit within the meaning of 1954 Code § 165(c)(2) or as an expense of maintaining property held for the production of income within the meaning of § 212(2).

2. Whether the lower court erred in denying petitioner's motion for leave to amend his complaint.

3. Whether the court below correctly held that petitioner was not entitled to a deduction in order to achieve equality with other taxpayers similarly situated.

STATUTES INVOLVED

Internal Revenue Code of 1954:

> SEC. 165. LOSSES.
>
> (a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> * * * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *

* * * *

(26 U.S.C. 165.)

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * * *

(2) for the management, conservation, or maintenance of property held for the production of income; * * *

* * * *

(26 U.S.C. 212.)

STATEMENT

Most of the underlying facts in this case were previously before this Court in *Knetsch* v. *United States*, 364 U.S. 361 (Pet. 1a-2a).

On December 11, 1953, petitioner purchased from Sam Houston Life Insurance Company ten 30-year maturity deferred annuity savings bonds, each in the face amount of $400,000, and bearing interest at the rate of 2½ percent compounded annually. The total purchase price was $4,004,000. Petitioner gave the

company his check for only $4,000 and signed $4,000,000 of non-recourse notes for the balance, the notes bearing 3½ percent interest and being secured by the annuity bonds. Thereafter petitioner made annual "interest" payments to the insurance company and at about the same time each year "borrowed" from the insurance company the full increase in the cash value of the annuity savings bonds. The net result of these transactions was that the annuity policies were never worth more than $1,000. Petitioner surrendered the annuity bonds on December 27, 1956, offsetting the $4,308,000 cash value of the bonds against his $4,307,000 indebtedness, and receiving the $1,000 balance in cash. Because petitioner had paid "interest" at the rate of 3½ percent and earned interest at the rate of only 2½ percent, he had an out-of-pocket loss on the entire transaction of $137,315.

Petitioner claimed a deduction for his "interest" payments in 1953-1955, but the Commissioner disallowed these deductions. In *Knetsch* v. *United States*, 364 U.S. 361, 366, this Court upheld the Commissioner on the ground that the entire transaction was a sham with "nothing of substance to be realized by Knetsch * * * beyond a tax deduction" for the so-called "interest" payments.

Thereafter petitioner brought this suit, claiming the right to deduct in 1956, the year he surrendered the annuity contracts, his $137,000 out-of-pocket loss on the entire transaction. The Commissioner disallowed the deduction, and the Court of Claims granted summary judgment in favor of the government. The court stated that the transaction was not entered into

for profit, but rather was part of a scheme designed solely to obtain a tax deduction. Therefore, it held that petitioner's loss was not "incurred in any transaction entered into for profit" within the meaning of § 165(c)(2) of the 1954 Code, nor was it "an ordinary and necessary expense" for "the management, conservation, or maintenance of property held for the production of income" within the scope of § 212(2). The court also held that the Internal Revenue Service was not required to give petitioner a loss deduction in 1956, when he closed out the annuity transaction, merely because it had allowed those taxpayers who had relied to their detriment on erroneous letter rulings to deduct a portion of their "interest" payments, *i.e.*, to deduct that part of the "interest" payment equal to their out-of-pocket costs. Petitioner, the court found, was not seeking deductions for 1953-1955 when he made "interest" payments, but was asking for a loss deduction on the cancellation of his annuity in 1956. (Pet. 1a-4a; 364 U.S. at 362-364.)

ARGUMENT

The decision below is correct and there is no conflict of decisions warranting review by this Court.

1. The determination of the court below that petitioner did not enter into the annuity transaction with any intent to realize a profit apart from the tax benefits and that his out-of-pocket costs were thus not a loss deductible under § 165(c)(2) is clearly in accord with this Court's decision in *Knetsch* v. *United States*, 364 U.S. at 366. In that case the Court held

that the annuity transaction here in question was a sham from which petitioner stood to realize nothing of substance beyond the creation of a tax deduction. See also *Gregory* v. *Helvering*, 293 U.S. 465; *Gerstell* v. *Commissioner*, 319 F. 2d 131 (C.A. 3), certiorari denied, 375 U.S. 941. Similarly, in the absence of a profit motive petitioner's loss cannot qualify as an expense paid or incurred during the taxable year for the conservation or maintenance of property held for the production of income within the meaning of § 212 (2). *United States* v. *Gilmore*, 372 U.S. 39, 48.

Petitioner's argument (Pet. 9-10) that summary judgment is improper when motive is an ultimate fact is plainly inapplicable here where the facts of the transaction itself show that petitioner could not have entered into it for profit, and where, in addition, petitioner is collaterally estopped by the determination of that issue in the prior litigation. *Commissioner* v. *Sunnen*, 333 U.S. 591, 597-598, 601.

2. Petitioner's contention (Pet. 5-7) that the Court of Claims abused its discretion in refusing him leave to amend his complaint to claim a deduction for a theft loss is without merit. Where it is clear that an amendment would be futile, the court may properly deny leave to amend. See *Foman* v. *Davis*, 371 U.S. 178, 182; *Kinsley* v. *Markovic*, 333 F. 2d 684 (C.A. 4). Petitioner's requested amendment was patently without merit for at least two reasons. First, petitioner was barred by the statute of limitations from making the arguments contained in the amended complaint. No new claim for refund may be filed more than two years after payment of the tax or three

years after filing of the return, whichever is later. 1954 Code § 6511; *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 17-18; *United States* v. *Garbutt Oil Co.*, 302 U.S. 528. This period had long since expired when petitioner in March 1965 filed his second claim for refund—the only one presenting the theft loss argument—with the IRS and asked the Court of Claims for leave to file an amended complaint.[2]

Second, it is clear that the allegations stated in the amendment do not state a claim for a theft loss deduction.[3] Even if, as petitioner alleges, he made payments to the insurance company in 1953-1955 only because an agent of the company fraudulently represented that the payments would be tax deductible, no such payments were made in 1956, the only year here in question. Moreover, petitioner nowhere alleges that the insurance company is insolvent or that he is otherwise prevented from recovering his money from it.

3. The Court of Claims also properly rejected petitioner's contention (Pet. 17-18) that although he was not entitled to a loss deduction under the substantive provisions of the Code, he was nevertheless entitled to such a deduction in order to achieve equality of treatment with other taxpayers similarly situated. The Service had given letter rulings to a number of

---

[2] The 1956 taxes here in question were paid no later than January 1961; petitioner's original claim for refund was disallowed in July 1962 (R. 9). The record does not indicate that the second claim for refund was filed before March 1965 (R. 225).

[3] While petitioner asserts that three theories were stated in the amended complaint, he mentions only the theft loss ground in his petition for certiorari (Pet. 5, fn. 8).

taxpayers stating that "interest" payments on contracts similar to those purchased by petitioner would be deductible. The Service later revoked those rulings retroactively, but allowed taxpayers who had acted to their detriment in reliance on such rulings (whether or not issued to them) to deduct so much of the "interest" payments as did not exceed their out-of-pocket costs, *i.e.*, the Service allowed a deduction for that portion of the "interest" paid which exceeded the amount received as a "loan" (Pet. 15a; R. 267-280, 296).[4] Petitioner, however, did not request a deduction for his net out-of-pocket expenses in the years 1953-1955, but instead claimed a loss deduction for the year 1956 when he closed out the transaction (Pet. 15a-16a). Certainly where, as here, there is no indication that any taxpayer has been given a deduction denied to this taxpayer, the court below did not abuse its discretion in refusing to grant petitioner the right to examine Internal Revenue Service of-

---

[4] The record demonstrates that this was the treatment given to Mr. R.C. Salley, president of the Sam Houston Life Insurance Company, whose private ruling petitioner claims to have seen and relied upon. The Service's letter of June 29, 1954, notifying Salley of the revocation of the prior erroneous ruling concluded (R. 220):

> Therefore, deduction by you of the so-called interest for the period August 1, 1952 (the date of the original ruling) to November 23, 1953 (the date you were advised that the ruling could no longer be relied upon) will not be disallowed to the extent that such disallowance would result in a detriment to you. The amount of any detriment which you may have incurred will be determined by the examining officer upon examination of your return for the years involved.

ficials in an attempt to determine whether any other taxpayers had been treated differently than petitioner.

Moreover, in making his 1953-1955 "interest" payments petitioner did not rely upon an effective ruling. Eighteen days before petitioner contracted for his first annuity, the Service notified R.C. Salley, president of the Sam Houston Life Insurance Company (who had previously received a ruling that such "interest" payments were deductible in full) that consideration was being given to revoking his ruling, that "no further rulings will be issued approving the type of transaction involved," and that it could not advise him as to the extent that it would recognize reliance on the ruling by him or others (R. 3, 219). Thus, even though petitioner may have relied upon the ruling to Salley in entering into the annuity transaction, his loss was not attributable to the action of the Service, but to the insurance company's failure to inform him of the ruling's doubtful status at the time he signed the contracts. The Service made no representations to petitioner when it issued the original ruling to Salley, and it had no duty to notify petitioner or anyone else when it informed Salley that it was correcting its position. If the insurance company made a material misrepresentation and petitioner voluntarily chose not to pursue his remedies against the company, he can hardly be entitled to claim that he has involuntarily sustained a deductible loss. *Juniper Investment Co.* v. *United States*, 338 F. 2d 356 (Ct. Cl.).[5]

---

[5] Moreover, even if petitioner had been entitled to rely on the Salley ruling, two of the three "interest" payments which

Contrary to petitioner's contentions, there are no conflicting decisions by this or any other appellate court. Petitioner's citations (Pet. 18) do not support his claim to equal though erroneous tax treatment. The citation to the concurring opinion in *United States* v. *Kaiser*, 363 U.S. 299, 308, involving the taxability of strike benefits, is merely to Mr. Justice Frankfurter's restatement of the taxpayer's argument (which he found to be inapplicable in any event). Nor is *Dixon* v. *United States*, 381 U.S. 68, authority for petitioner's position. Indeed, that decision upheld the Commissioner's discretionary authority under Section 7805(b) of the Internal Revenue Code of 1954 to distinguish between different taxpayers who had relied upon an erroneous published ruling by revoking the ruling retroactively as to one group but only prospectively as to the other. Petitioner's citation (381 U.S., p. 77, fn. 9) is again to the Court's restatement of an argument which had been made by the taxpayer but which the Court found inapplicable. Finally, petitioner's reliance (Pet. 5, 18) upon *International Business Machines Corp.* v. *United States*, 343 F. 2d 914 (Ct. Cl.), certiorari denied, January 31, 1966, is misplaced. That case, which was decided by the same court that decided the instant case, "was based on the court's evaluation of the particular cir-

---

caused petitioner's out-of-pocket loss on the transaction were made after official publication of Rev. Rul. 54-94, 1954-1 Cum. Bull. 53, in March, 1954, stating that such "interest" payments were non-deductible. Since petitioner was free to cancel the annuity contracts at will (R. 221), in no event can he claim that he made any payment after March, 1954, in reliance on the prior letter ruling to Salley.

cumstances in that case" (Pet. 14a, fn. 14).[6] See also *Bookwalter* v. *Brecklein* (C.A. 8), decided March 1, 1966.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

RICHARD M. ROBERTS,
Acting Assistant Attorney General.

HARRY BAUM,
PHILIP R. MILLER,
Attorneys.

MARCH, 1966.

---

[6] Nor is there any merit to petitioner's contention (Pet. 19) that the government was equitably estopped from denying the deduction because petitioner relied upon letter rulings issued to other taxpayers. In addition to the reasons given above (pp. 7-9, *supra*), it is well established that "The doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." *Automobile Club* v. *Commissioner*, 353 U.S. 180, 183; see also *Dixon* v. *United States*, 381 U.S. 68, 72-73, 76.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1966 209470 630

LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
MAR 17 1966
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH, *Petitioners*,

v.

UNITED STATES OF AMERICA

PETITIONER'S REPLY BRIEF

WILLIAM LEE MCLANE
NOLA MCLANE
THADDEUS ROJEK
2101 Connecticut Avenue, N.W.
Washington, D. C.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH, *Petitioners,*

v.

UNITED STATES OF AMERICA

PETITIONER'S REPLY BRIEF

When, in 1959, petitioners asked this Court to allow them annuity interest deductions for the years 1953 and 1954, the Solicitor General argued against the allowance of any part thereof and told this Court that when Internal Revenue Service officials stated to Congress that they had *allowed* taxpayers who had purchased similar annuities a deduction for their "net out-of-pocket expense", those officials meant "net out-of-pocket investment". The Solicitor General then immediately equated "net out-of-pocket investment" with "a *loss* deduction based upon [taxpayer's] out-

of-pocket *loss* incurred at the time of termination of his contracts".[1]

If, as petitioners submit it is, it is wrong for the Attorney General to tell this Court that civil contempt is not a crime while at the same time advising the Department of Defense that it is, then certainly it is equally wrong for the Solicitor General to tell this Court that the same statement of policy made by the Commissioner of Internal Revenue meant one thing in 1959 (in order to prevail in the first *Knetsch* case) whereas he now tells the Court that it meant

---

[1] Brief for the United States, Knetsch v. United States, No. 23, October Term, 1960, pp. 50-51:

"... Those officials did not say that the recipients of ruling letters would be exempted entirely from the retroactive effect of Rev. Rul. 54-94, *supra*. Mr. Swartz stated that (p. 192)—

> we would allow them a deduction for the out-of-pocket money they have spent, not the full interest deduction, but the extent to which they had relied on it [the ruling letter] to their detriment. * * * We allowed a deduction to the extent of the net out-of-pocket expense.

In the case at bar, as we have seen, the taxpayer's net out-of-pocket expense, his investment in Sam Houston, was far less than the claimed deductions for "prepayments of interest". Even if his position were deemed identical with that of recipients of the ruling letters, the Commissioner would allow deduction only of his net out-of-pocket investment in Sam Houston. Taxpayer has indeed claimed (in his 1956 return) a loss deduction based upon his out-of-pocket loss incurred at the time of termination of his contracts with Sam Houston. But that claim is not a part of this case and, whatever its merit, it is obviously discrete from the much larger claim (here involved) predicated upon the payment of "interest" during the period prior to termination.[14]

---

[14] The claim advanced by taxpayer in his 1956 return is still pending before the Commissioner."

exactly the opposite (in order to prevail herein).[2] That is, the Solicitor General, at the time petitioners sought annual interest deductions as a result of the instant annuity transactions, told this Court that if petitioners were entitled to anything, it was only a net out-of-pocket *loss* deduction realized upon termination of the annuity contracts. However, now that petitioners seek that net out-of-pocket loss deduction realized upon termination of the annuity contracts, the Solicitor General, at page 8 of his brief in opposition, volte face, tells this same Court that the Internal Revenue Service officials meant that they had "allowed" not net out-of-pocket loss deductions but "so much of the *interest* payments as did not exceed their out-of-pocket costs" each year.

Not only does this "new" view of the Solicitor General undermine this Court's decision in *Knetsch* v. *United States,* 364 U.S. 361,[3] but it is contradicted by the concession made by the Government herein (in its motion for summary judgment) that the Internal Revenue Service had allowed a net out-of-pocket *loss.*

Furthermore, earlier this term the Solicitor General asked the Court to review *International Business*

---

[2] The two conflicting statements are contained in separate briefs submitted by the Government in which the same Department of Justice attorney appears as counsel. Therefore, such contradictory statements cannot even be explained on the ground that different counsel were responsible therefor.

[3] Since this Court's decision and opinion therein disallowed *all* of the claimed interest deductions, this new argument of the Solicitor General that the taxpayers were entitled to and allowed an "interest" deduction each year equal to their net out-of-pocket loss is in conflict therewith. It is also in conflict with the facts since, as this Court well knows, there was no allowance by the Commissioner in Knetsch v. United States, 364 U.S. 361 of any part of the claimed interest deductions.

Machines Corporation v. *United States,* 343 F. 2d 914,[4] —a case in which the Court of Claims had applied the doctrine of "equality of treatment of taxpayers similarly situated" in favor of the taxpayer therein. In seeking review thereof for the purpose of obtaining a determination by this Court of whether or not there is such a doctrine of tax law and, if so, the extent of its applicability, the Solicitor General invoked ominous phrases such as "The courts basic holding . . . has *far-reaching implications,*"[5] and "the decision below poses a *serious threat* to the continued operation of the Commissioner's important rulings program . . .".[6] He also postulated the hypothetical danger that ". . . the courts may reason that if taxpayers are entitled to equality, they also are entitled to discover how other taxpayers have been treated," and concluded that "such a view would result in extensive discovery of documents filed with the IRS . . .".[7] Since the instant case affords an opportunity for a review of the same doctrine of law, having the same "far-reaching implications," it is surprising that the Solicitor General now objects to the granting of certiorari herein.

It is also surprising that the Solicitor General has neither responded to nor answered most of the reasons set forth by petitioners as to why certiorari should be granted. The most significant omission in the Solicitor General's brief in opposition is his failure

---

[4] United States v. International Business Machines Corporation, No. 820, October Term, 1965.

[5] Ibid., at p. 14.

[6] Ibid., at p. 17.

[7] Ibid., at p. 15.

to explain how the Court of Claims could have granted the *Government's* motion for summary judgment in view of the facts which had been conceded to be true by the Government for the purposes of that motion, and which concessions it did not deny in its brief in opposition herein. The Government had conceded as *true* that the Commissioner of Internal Revenue told the Congress in 1957 that "while *interest* deductions claimed in regard to annuity transactions were being *denied* taxpayers who claimed same" he "was, as a matter of policy, *allowing* such taxpayers a deduction for their net out of pocket *loss realized* from such annuity transactions where the taxpayer had acted in reliance on references to trade magazines and the tax services to the issuance of private rulings by the Treasury Department stating that interest paid in connection with such annuity transactions was deductible for income tax purposes." It was also conceded as true that Knetsch had acted in reliance on such references to private rulings.[8] The application of the doctrine that "taxpayers similarly situated should be accorded equal treatment" to such conceded facts requires a ruling in favor of taxpayers and thus precluded the granting of summary judgment in favor of the Government.

In addition, the Solicitor General has neither responded to nor answered the following additional reasons why the writ should issue:

---

[8] The Solicitor General is being less than accurate when he attempts to leave the inference at page 9 of his brief that the only ruling relied upon by Knetsch was the Salley ruling. See allegations contained in paragraphs 5 and 6 of Petition (R. 2-3) which were admitted as true for purposes of the Government's motion. See further, the deposition of Knetsch contained in the Record, together with the rulings attached as exhibits thereto.

1. The Court of Claims abused its discretion by refusing outright to grant plaintiffs leave to amend without setting forth any justification whatsoever for such action. (Such action conflicts with this Court's decision in *Foman* v. *Davis*, 371 U.S. 178.)[9]

2. The Court of Claims erred in granting the Government's motion for summary judgment while plaintiffs' motion to amend their petition (complaint) was pending. (Such action conflicts with the decisions of at least three circuits.)[10]

3. The Court of Claims erred in granting the Government's motion for summary judgment where ultimate facts respecting motive and intent must be made. (Such action conflicts with the decisions of this Court and those of at least two circuits.)[11]

---

[9] Petition for Certiorari, Point I, pp. 5-7. Such failure on the part of the Court below is not cured by the Government setting forth in its brief in opposition herein its present views as to why the said motion to amend should not be granted. As to the merits of the argument now presented by the Government, it should be noted that the statute of limitations does not bar an amended claim for refund which does not present new or unrelated matters or facts which the Commissioner was not on notice of, but merely asserts new legal theories of recovery. Consolidated Coppermines Corporation v. United States, 296 F. 2d 743, 155 Ct. Cl. 731. Furthermore, the 1954 Code provides a theft loss is deductible in the year in which it is discovered and not the years in which it may have occurred (Sec. 165 (e)). "The right to take the loss will not be defeated by the fact that the taxpayer has a right of action against irresponsible persons", and he need not first exhaust his legal remedies against the culprits. 5 Mertens', Law of Federal Income Taxation, Sec. 28.59.

[10] Ibid., Point II, pp. 7-8.

[11] Ibid., Point III, pp. 9-10.

4. The Court of Claims erred in drawing repeated fact inferences as to the intention of Knetsch and Harold T. Swartz on a motion for summary judgment. (Such action conflicts with the decision of at least three circuits.)[12]

5. The Court of Claims erred in granting the Government's motion for summary judgment since genuine issues of material fact were present. (Such action conflicts with the decisions of this Court.)[13]

6. The Court of Claims erred in granting the Government's motion for summary judgment since, viewing the underlying evidentiary facts in the light most favorable to plaintiffs, inferences contrary to those drawn by the trial court might be permissible. (Such action conflicts with the decisions of this Court.)[14]

7. The Court of Claims erred in not applying its doctrine of equitable estoppel so as to prevent a wrong being done since "in good conscience and honest dealing" the Commissioner ought not to be permitted to repudiate his previous statements and declarations to Congress. (Such action conflicts with the Court of Claims' decisions.)[15]

---

[12] Ibid., Point IV, pp. 11-15.

[13] Ibid., Point V, pp. 15-17.

[14] Ibid., pp. 14-15, 17.

[15] Ibid., pp. 19-20. The Solicitor General has misstated this argument (p. 11, n. 6). Petitioners seek the same deduction which the Commissioner told Congress he had allowed other taxpayers who had not themselves been issued a ruling, but who had relied on the position taken by the IRS in other private but publicized annuity interest rulings. The Commissioner has never taken the position, publicly at least, that he had been in error, as a matter of law, when he made that statement to Congress.

8. The Court of Claims erred in rejecting the long-established rule that the profit making motive and intention of a taxpayer required under section 165 is a matter of subjective intent, and in fashioning and following a new rule that such motive or intention is to be determined from *objective* factors.[16]

9. The Court of Claims erred in fashioning and applying a new rule of tax law, to wit, "there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been 'without economic substance' or a 'sham'."[17]

10. The effect of the decision below is punitive in nature and permits the Commissioner to realize a net profit after he has been instrumental in causing taxpayers to be misled to their detriment.[18]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

WILLIAM LEE MCLANE
NOLA MCLANE
THADDEUS ROJEK
2101 Connecticut Avenue, N.W.
Washington, D. C.

[16] Ibid., pp. 20-21.

[17] Ibid., pp. 21-22.

[18] Ibid., pp. 22-23.